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IN THE

Supreme Court of the United States

MICHAEL J. KNIGHT,
Trustee of the William L. Rudkin Testamentary Trust,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF OF AMICUS CURIAE OF THE TAX SECTION OF THE FLORIDA BAR IN SUPPORT OF PETITIONER

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QUESTION PRESENTED

Whether investment advisory expenses incurred by a trustee in the administration of a trust are subject to the limitation on deductibility of miscellaneous itemized deductions under I.R.C. § 67(a), commonly referred to as the "2% Floor," or excepted from this limitation by reason of I.R.C. § 67(e)(1).

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INTEREST OF AMICUS CURIAE

The Tax Section of The Florida Bar (the "Tax Section") is a section of The Florida Bar with a mission to serve and support members and the community by: (i) furthering the tax knowledge and practice of interested members of The Florida Bar in federal and state tax law; (ii) developing standards for ethical and competent practice of tax law by lawyers; (iii) developing and maintaining proper professional relationships between tax lawyers, nonlawyer groups and other lawyer groups; and (iv) improving the operation of the federal and state tax laws, rules and regulations, to accomplish legitimate legislative objectives and to improve the administration of tax law. It is with the intent to improve and accomplish legitimate operation of the tax law that we file this Amicus Brief.[1]

The Tax Section strives to protect and assist the public to ensure proper application of the federal tax laws including the income taxation of trusts and estates. According to the Florida Department of Health, Office of Vital Statistics, an estimated 170,300 Florida residents died in 2005. Florida Department of Health, Office of Vital Statistics, *Florida's Chart for Deaths of All Causes*, *http://*www.floridacharts.com/charts /DeathQuery.aspx (accessed July 27, 2007). An estate (and one or more trusts) is frequently created as a result of these deaths. In addition, there are many inter vivos and testamentary trusts currently being administered and more created each year. In virtually all cases, a fiduciary is appointed to administer the property held in an estate or trust. A fiduciary does not own the assets of the estate or trust personally. Rather, a fiduciary administers those assets for the benefit of others, subject to substantial fiduciary obligations under State law. It has been said that a trustee must

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1. The parties have consented to the filing of this brief and letters of consent have been filed with the Clerk. In addition, pursuant to Supreme Court Rule 37.6, the Tax Section affirms that no party has written this brief in whole or in part and that no person or entity, other than the amicus or its attorneys, has made a monetary contribution for the preparation or submission of this brief.

act with "a punctilio of an honor the most sensitive." *Meinhard v. Salmon*, 164 N.E. 545 (N.Y. 1928). To acquit his or her fiduciary obligations, a fiduciary will incur expenses and may be personally surcharged. Many of those expenses are necessary to the proper administration of the estate or trust under State law and are incurred in response to specific fiduciary duties imposed under the law. *Bingham's Trust v. CIR*, 325 U.S. 365 (1945) (after considering the proximate relationship between expenses incurred and property held by the trust, a deduction was allowed for legal expenses concerning taxation of current distribution of appreciated property).

The specific issue presented in this case is whether investment advisory expenses incurred by a trustee in the administration of a trust[2] are subject to the limitation on deductibility of miscellaneous itemized deductions under I.R.C. § 67(a), commonly referred to as the "2% Floor," or excepted from this limitation by reason of I.R.C. § 67(e). This Court's decision on the proper construction of I.R.C. § 67(e) in this case will determine the extent to which investment advisory expenses incurred by fiduciaries are deductible "above the line" or "below the line." Therefore, as a friend of the Court, the Tax Section is interested in submitting an analysis and assisting the Court in interpreting I.R.C. § 67(e) due to the significant impact on trusts and estates, particularly in Florida.

SUMMARY OF THE ARGUMENT

I.R.C. § 67(a), enacted by the Tax Reform Act of 1986, *See* Tax Reform Act, *Pub. L. No. 99-514, 100 Stat. 2085, § 132(a)*, provides that miscellaneous itemized income tax deductions are allowed only to the extent that the aggregate of such deductions exceeds 2% of the taxpayer's adjusted gross

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2. The present case involves a trust. However, I.R.C. § 67(e) applies to trusts and estates. For ease of reference, when we refer to "trustee" we mean to include trustees, executors and personal representatives and when we refer to "trust" we mean to include both trusts (specifically non-grantor trusts) and estates.

income.[3] This limitation applies to individuals, estates and trusts. *I.R.C. § 67(a), (b); See also Treas. Reg. § 1.67-1T(a)(1) (The deductions limited by the 2% Floor are commonly referred to as below-the-line deductions).* However, I.R.C. § 67(e) provides that the 2% Floor does not apply to costs paid in connection with trust administration which would not have been paid if property were not held in trust. Amicus urges this court to determine the meaning of the "which would not have been incurred" language in the second prong of I.R.C. § 67(e)(1) to require a proximate relation between the cost incurred and the fiduciary obligation of the trustee. In determining the meaning of such language, we have analyzed the language of the Internal Revenue Code ("Code"), judicial precedent, legislative history and the unique nature of trusts[4] in general.

The language of I.R.C. § 67(e) does not elaborate on the meaning of the "which would not have been incurred" language of I.R.C. § 67(e)(1). However, with respect to investment advisory expenses, other sections of the Code, including I.R.C. §§ 212, 2053, suggest that investment advisory expenses of trusts should be deducted in full and not subject to the 2% Floor because such fees are incurred i.e., in the fiduciary context.

The Circuit Courts have been unable to construe I.R.C. § 67(e)(1) consistently; however, each court understood the "would not have been incurred" language of I.R.C.§ 67(e)(1) to

3. "Adjusted gross income" is defined in I.R.C. § 62. Certain itemized deductions and other expenses are deducted from gross income, defined in I.R.C. § 61, to determine adjusted gross income. Other itemized deductions and expenses are deducted from a taxpayer's adjusted gross income to determine the taxpayer's taxable income against which the income tax under I.R.C. § 1 is imposed. Deductions allowed in determining adjusted gross income, along with the twelve items specified in I.R.C. § 67(b), are not subject to the 2% Floor.

4. The present case involves a trust. However, I.R.C. § 67(e) applies to trusts and estates. For ease of reference, when we refer to "trustee" we mean to include trustees, executors and personal representatives and when we refer to "trust" we mean to include both trusts (specifically non-grantor trusts) and estates.

require a connection between the cost incurred and the fiduciary relationship. The Sixth Circuit accurately recognized the fiduciary relationship between trustees and trust property and linked the "would not have been incurred" language of I.R.C. § 67(e)(1) to the fiduciary relationship of trustees and trust property.

A review of the legislative history reveals that the intended purpose of the "which would not have been incurred" language was to prevent the use of pass-through entities to circumvent the 2% Floor. The legislative history does not support the contention that Congress intended to deny a deduction for investment advisory expenses incurred by trustees in connection with acquitting their fiduciary obligations.

Meaningful interpretation of the "would not have been incurred" language of I.R.C. § 67(e)(1) is rooted in understanding the fiduciary relationship between trustees and trust property. Trustees differ fundamentally from individuals in their relationship to the property they are investing. Trustees are obligated, in most jurisdictions, to prudently invest the trust assets as part of the trustee's fiduciary obligations to the trust property and beneficiaries. Failure to prudently invest the trust assets may subject the fiduciary to personal liability, an exposure not experienced by an individual investing his or her own assets. Expenses incurred in furtherance of this fiduciary relationship would not be incurred outside the trust context. Regarding the investment advisory expenses at issue in this case, a trustee incurs these fees only in the context of carrying out the duties that the trustee has to the beneficiaries with respect to the trust assets. As a result, investment advisory expenses incurred by a trustee always have a relation to the trustee's fiduciary duties and obligations. Because of the fiduciary relationship between the trustee and trust property, investment advisory expenses incurred in the administration of a trust should be deductible in full under I.R.C. § 67(e)(1) without regard to the 2% Floor.

ARGUMENT

A. The Interpretation of the Limiting Language in I.R.C. § 67(e)(1) Should be Informed by, and Consistent with I.R.C. § 212.

I.R.C. § 212 provides a deduction to individuals for all the ordinary and necessary expenses paid or incurred during the taxable year for any of the following: (i) the production or collection of income, (ii) the management, conservation, or maintenance of property held for the production of income, or (iii) in connection with the determination, collection, or refund of any tax. I.R.C. § 212. Although I.R.C. § 212 provides a deduction to individuals for the expenses described above, such deductions are limited and allowed only to the extent that the aggregate of such deductions exceeds the 2% Floor. I.R.C. § 67(e) extends this limitation to trusts by providing that the adjusted gross income of a trust is computed in the same manner as in the case of an individual. I.R.C. § 67(e). However, I.R.C. § 67(e)(1) provides that certain deductions of trusts will not be limited by the 2% Floor, including the "deductions for the costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate." I.R.C. § 67(e)(1).[5]

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5. On July 26, 2007, the United States Treasury Department filed in the Federal Register a notice of proposed rulemaking which contains proposed regulations that "provide guidance on which costs incurred by trusts are subject to the 2% floor for miscellaneous itemized deductions under I.R.C. § 67(a)." Federal Register, *Section 67 Limitations on Estates or Trusts*, Vol. 72, No. 144, Friday, July 27, 2007, p. 41243. The proposed regulations provide that costs incurred by trusts that are unique to a trust are not subject to the 2% floor. For this purpose, a cost is unique to a trust if an individual could not have incurred that cost in connection with property not held in a trust. Furthermore, the proposed regulations provide that services for the custody or management of property and advice on investing for total return are not unique. According to the Notice, the regulations, as proposed, apply to

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This exception to the 2% Floor recognizes that a trustee has a different relationship to the trust property than an individual has with their own personal assets. Specifically, a trustee may incur costs in connection with the fiduciary relationship inherent in trust administration. The expenses of a trustee that are a product of their fiduciary obligations should not be subject to the 2% Floor. Therefore, in order to escape application of the 2% Floor, I.R.C. § 67(e)(1) requires a nexus between the fiduciary relationship and the cost incurred by stating that the cost incurred must be one "which would not have been incurred" if the property were not held in trust. The critical question presented is what exactly is that nexus.

I.R.C. § 212 provides individuals, trusts and estates with a deduction for expenses for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income. I.R.C. § 212. The Treasury Regulations further provide that fees of investment counsel and similar expenses paid or incurred by a taxpayer in connection with investments held by such taxpayer are deductible under I.R.C. § 212 only if:

> (1) they are paid or incurred by the taxpayer for the production or collection of income or for the management, conservation, or maintenance of investments held by the taxpayer for the production of income, and (2) they are ordinary and necessary under all the circumstances, having regard to the type of

(Cont'd)
payments made after the date final regulations are published in the Federal Register. Therefore, the proposed regulations do not apply to the case at bar. Nonetheless, the U.S. Supreme Court's decision in the case at bar can determine whether any such regulation is valid. In any event, even if the "would not" limitation contained in I.R.C. § 67(e)(1) is construed as "could not" as the Second Circuit and these proposed regulations do, it is contended, as discussed in the text of this brief, that an individual could not incur the expenses that a trust properly incurs because the individual is not acting pursuant to a fiduciary relationship as is a trustee.

> investment and the relation of the taxpayer to such investment.

See Treas. Reg. § 1.212-1(g). The first condition merely requires the investment advisory expenses be connected to the income or investments of the taxpayer. The second condition requires the investment advisory expenses be ordinary and necessary in the context of the type of investment and the relation of the taxpayer to the investment. Expenses are "ordinary and necessary" if such expenses are reasonable in amount and bear a reasonable and "*proximate relation* to the production or collection of taxable income or to the management, conservation, or maintenance of property held for the production of income" (emphasis added). Treas. Reg. § 1.212-1(d).

Importantly, I.R.C. § 212 does not require that the investment advisory expenses be "necessary" to the production or collection of income or the maintenance, conservation or management of property in a "but for" sense. Rather, I.R.C. § 212, as interpreted by the Treasury Regulations, requires only a "proximate relation" between the two. Treas. Reg. § 1.212-1(d). Similarly, I.R.C. § 67(e)(1) requires a connection between the cost incurred and the administration of a trust by stating that the cost must be one that "would not have been incurred" if the property were not held in such trust. When the issue is the deductibility of investment advisory expenses, Amicus submits that the interpretation of this limiting language in I.R.C. § 67(e)(1) should be informed by, and consistent with, I.R.C. § 212, its parent statute. Therefore, the interpretation of I.R.C. § 67(e)(1) also mandates a "proximate relation" between the investment advisory expenses and the administration of the particular trust in question.

Individuals are free to invest however they choose and have no obligation to invest in a prudent manner when they manage their own assets. On the other hand, trustees have a fiduciary obligation to prudently invest consistent with substantial fiduciary duties imposed under state law. Fla. Stat. § 518.11 (2007). The essence of a fiduciary relationship is that a fiduciary holds, manages and controls property for the benefit of others. Therefore, fiduciaries are accountable in a way that individuals

are not for the consequences of the investment decisions that they make, and are personally liable to the beneficiaries for failing to properly acquit that most fundamental of fiduciary duties. Restatement (Third) of Trusts §§ 90, 91 (2007). In addition, a fiduciary must invest the assets under the fiduciary's control in a manner consistent with the obligations imposed on the fiduciary by the terms of the governing instrument under which the fiduciary acts, be it a will or a trust agreement. *Id.* The duration of the fiduciary relationship, the objectives of the testator or settlor as set forth in the will or trust, and the identity of the beneficiaries are among the many factors that a fiduciary must consider when a fiduciary determines the appropriate investment policy for the assets under the fiduciary's control. An individual is not required to take such factors into account.

The unique nature of the particular fiduciary relationship will formulate the investment policy that a fiduciary determines to be appropriate. If the fiduciary determines to engage independent investment advisors thereby incurring investment advisory expenses, the investment advisor must in turn take into account the restrictions imposed by the fiduciary relationship.[6] Accordingly, the investment advice rendered will bear a proximate relation to the fiduciary obligations imposed by specific requirements of the particular trust. That proximate relation between incurring the costs of investment advisory expenses and the duties imposed on the trustee by State law and the terms of the will or trust satisfies the requirement of I.R.C. § 67(e)(1) that the particular cost would not have been incurred if the property were not held in trust. Therefore, investment advisory expenses paid in the fiduciary context by trustees, being informed by and therefore proximately related to the fiduciary relationship, are not subject to the 2% Floor.

6. Indeed, under the laws of most States, if a fiduciary is authorized to delegate investment decisions to an investment advisor, the investment advisor becomes accountable to the beneficiaries of the estate or trust as a fiduciary, and submits to jurisdiction in the place where the estate or trust is being administered for purposes of lawsuits by beneficiaries. Fla. Stat. § 518.112 (2007).

This construction of I.R.C. § 67(e)(1) is consistent with the plain meaning of the statute, the manner in which trusts are taxed generally under the Code, the legislative history and sound tax policy. Amicus further submits that it is the only construction susceptible of reasonable administration without unduly burdening fiduciaries with hair-splitting allocations of costs incurred in connection with the administration of a trust in a manner never intended by, and nowhere else present in, the Code.

B. Though Circuit Courts Interpret I.R.C. § 67(e)(1) Inconsistently; Each Reviewing Circuit has Read the "Would Not Have Been Incurred" Language of I.R.C. § 67(e)(1) to Require a Connection Between the Cost Incurred and the Fiduciary Relationship.

In the present case, the Second Circuit found that the plain text of I.R.C. § 67(e) requires that fees are exempt from the 2% Floor only if they "*could not* have been incurred if the property were held by an individual" (emphasis added). *William L. Rudkin Testamentary Trust v. CIR*, 467 F.3d 149 (2d. Cir. 2006). If the Second Circuit's interpretation of I.R.C. § 67(e) is followed, the only expenses that would qualify for the exemption for trusts from the 2% Floor would be expenses an individual is incapable of incurring. In reality, there are no costs that a fiduciary might incur that an individual is incapable of incurring. This interpretation significantly narrows the plain meaning of the statute. As a result, the Second Circuit's holding would render all costs incurred in connection with the administration of an estate or trust subject to the 2% Floor. Not only does this holding rewrite the face of the statute, but it also varies greatly from the holdings in other Circuits that have considered this same issue.

In *O'Neill v. Commissioner v. CIR*, 994 F.2d 302, 303 (6th Cir. 1993), the co-trustees for the William J. O'Neill, Jr. Irrevocable Trust hired investment advisors to manage and invest the over $4.5 Million in assets held by the trust. The custodian of the trust deducted (above the line) the entire amount incurred

by the trust for the investment advisory expenses. *Id.* However, the Internal Revenue Service claimed that the investment advisory expenses were subject to the 2% Floor of I.R.C. § 67(a) and not excepted under I.R.C. § 67(e). *Id.* The Sixth Circuit stated that "certain expenditures unique to trust administration are excepted from the 2% floor." *Id.* at 303. The Sixth Circuit acknowledged that fiduciaries "uniquely" occupy a position of trust for others and have an obligation to the beneficiaries to exercise proper skill and care with the assets of the trust. *Id.* at 304. Individuals have no such obligation and suffer no penalties of potential liability if they act negligently for themselves. *Id.* The Sixth Circuit further recognized the unique relationship a fiduciary has to the assets that make the investment advisory expenses "*necessary*" within the meaning of I.R.C. § 67(e). *Id.* These fiduciary responsibilities distinguish investment advisory services when incurred on behalf of a trust as opposed to investment advisory services incurred on behalf of an individual investor. Based on this reasoning, the Sixth Circuit held that investment advisory expenses are not subject to the 2% Floor of I.R.C. § 67(a) because they are exempted under I.R.C. § 67(e). *Id.*

In *Mellon Bank v. U.S.*, 265 F.3d 1275, 1279 (Fed. Cir. 2001), the appellant argued that the expenses incurred for investment advisory services were necessary to fulfill its fiduciary obligations under State law. The U.S. Federal Circuit ("*Federal Circuit*") rejected the appellant's argument, because, in the court's opinion, it would render the second prong of the I.R.C. § 67(e) test superfluous. The court reasoned that since all fiduciary services are a requirement under State law, no fiduciary expense would be subject to the 2% Floor. *Id.* at 1281. The court listed expenses that would be fully deductible under I.R.C. § 67(e), *Mellon Bank*, 265 F.3d at 1281, including: fees paid to trustees, expenses associated with judicial accountings, and the costs of preparing and filing fiduciary income tax

returns.[7] Accordingly, the court held that the second prong of I.R.C. § 67(e) treats as fully deductible only those trust-related administrative expenses that are unique to the administration of trusts and not customarily incurred outside of trusts. *Id.*

Similarly, the Fifth Circuit held in *Scott v. U.S.*, 328 F.3d 132, 139-40 (4th Cir. 2003), that expenses commonly incurred by an individual are not excepted by I.R.C. § 67(e). The Fifth Circuit reasoned that finding a trust's investment advice expenses deductible would lead to the conclusion that all trust-related administrative expenses could be attributed to a trustee's fiduciary duties, rendering the second clause of I.R.C. § 67(e)(1) meaningless. *Id.* at 140. Although the court acknowledged that trust-related administrative expenses "solely attributable" to a trustee's fiduciary duties are fully deductible, the Fifth Circuit ultimately held that investment advice expenses are subject to the 2% Floor because these expenses are "often incurred" by an individual taxpayer. *Id.*

The issue is therefore solely one of degree - how close a connection is required. The plain text of the statute construed in the context of the manner in which trusts and estates are generally taxed under the Code requires no more than a proximate relationship between the expense incurred and the obligations of the fiduciary under state law.

Requiring a "proximate relation" between the expenses and the trust property does not render the second prong of I.R.C. § 67(e) superfluous. Not all costs incurred by a fiduciary are proximately related to the fiduciary duties imposed under state law. A fiduciary may incur costs that are incidental to maintenance and custody of the assets held by the fiduciary. Examples include bank fees and maintenance fees for rental

7. Certainly, the costs associated with preparing and filing income tax returns are not "unique" expenses of a trust. However, the court chooses to distinguish the preparing and filing of income tax returns in the context of a fiduciary as opposed to an individual. Similarly, we believe the costs of fiduciary investment advice should be distinguished from personal investment advice.

real estate. Those fees would be incurred regardless of who owned the property, and regardless of the specific duties owed by the fiduciary. Such incidental costs would be subject to the 2% Floor. Accordingly, the costs incurred by a fiduciary as a consequence of the fiduciary duties imposed under state law do not subsume all costs incurred by a fiduciary. Interpreting I.R.C. § 67(e) to permit the deduction of costs proximately related to complying with a fiduciary's fiduciary duties would render the limiting language of I.R.C. § 67(e) neither superfluous nor all encompassing, but rather strike an appropriate balance by permitting only costs proximately related to the duties of the fiduciary to be fully deductible.

C. Legislative History Does Not Support the Contention that Congress Intended to Deny a Deduction for Investment Advisory Expenses Incurred by Trustees in Connection with Satisfying Their Fiduciary Obligations.

Amicus believes that the plain meaning of I.R.C. § 67(e) can be derived from the text itself when construed in the context of other parts of the I.R.C. closely related to it, including I.R.C. § 212 previously discussed, and I.R.C. § 2053 addressing the deduction of administration expenses in the context of an estate. When the meaning of a statute can be derived from the text itself, there is no need to examine its legislative history. *See Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 520 U.S. 1, 6 (2000) (quoting *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 241 (1989) (quotation omitted)). However, at least one Circuit Court found it appropriate to examine the legislative history relating to I.R.C. § 67(e). *Mellon Bank*, 265 F.3d at 1281. Because Amicus believes that Court to have incorrectly determined its import, it is appropriate to address that analysis here.

The interpretation of the legislative history by the Federal Circuit in *Mellon* is fundamentally flawed. Finding the overall purpose of the Tax Reform Act of 1986 was to "increase fairness, economic efficiency, and simplification of the tax system," the

Federal Circuit cited House Report 99-426 for the proposition that Congress was concerned taxpayers were able to "exclude or deduct from income certain items that differ little from items that are treated as taxable compensation or nondeductible expenditures for other taxpayers." *Id.* The analysis of the Federal Circuit further emphasized the intent of Congress to treat taxpayers similarly by maintaining a fair tax system. *Id.* The Federal Circuit then stated that the goal of Congress was "to eliminate or reduce the tax benefit of placing assets in a trust" by enacting the Tax Reform Act of 1986. *Id.*

After reciting this legislative history, the Federal Circuit concluded that, in order for Congress to reach this goal, there was not "a *significant* change in the taxation of trusts, but [that this goal was reached] through the application of the two percent floor rule to deductions from trust income" (emphasis added). *Id.* This conclusion is faulty as it ignores: (i) the text of the House and Senate bills, (ii) the second clause did not emerge until Conference Committee; (iii) the explanation provided in the General Explanation of the Tax Reform Act of 1986 prepared by the Joint Committee on Taxation (the "Joint Committee Report") and (iv) the other *significant* changes to the taxation of trusts in the Tax Reform Act of 1986. *See* H.R. 3838, 99th Cong., 1st Sess., § 132 (as passed by the House, Dec. 17, 1985); H.R. 3838, 99th Cong., 2d Sess., § 133 (as passed by the Senate, June 24, 1986), *reprinted at* 132 Cong. Rec. 16,061, 16,070 (June 26, 1986), H.R.Rep. No. 99-841, vol II, at 34 (1986) (Conf.Rep.), *reprinted at* U.S.C.C.A.N. 4075, 4122. Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, JCS-10-87 (May 4, 1987). The Federal Circuit's failure to acknowledge these issues led it to the erroneous conclusion, without support of legislative history, that the legislative intent was "to equate the taxation of trusts with the taxation of individuals."

The exception in I.R.C. § 67(e) for trusts from application of the 2% Floor was approved by the House and Senate in H.R. 3838 with no changes to the language as proposed.

See H.R. Rep. 99-426, at 109-110 (1985); S. Rep. 99-313, at 78-79. The language, as approved by the House and Senate, was to except from the floor "costs paid or incurred in connection with the administration of [an] estate or trust." *Id.* Thus, the second clause in I.R.C. § 67(e)(1) ("would not have been incurred if the property were not held in such trust or estate") was not included in the Tax Reform Act of 1986 until added by the Conference Committee. *See* H.R.Rep. No. 99-841, vol II, at 34 (1986) (Conf.Rep.), *reprinted at* US.C.C.A.N. 4075, 4122. However, a review of the Conference Committee Report does not clearly discuss the meaning of the additional language or reasons for the change. *Id.* The limiting language is merely referenced between a general statement about the application of the 2% Floor to pass-through entities (i.e., grantor trusts, partnerships, and S corporations) and a statement regarding regulations to be prescribed by Treasury relating to the reporting requirements necessary to effectuate the provision. Thus, the meaning of this second clause, as it relates to non-grantor trusts, is not readily apparent from a review of the House reports or Senate report relating to the enactment of I.R.C. § 67(e)(1).

When there is scarce legislative history to support the intended meaning of a statute, an analysis of the broader context in which the statute is adopted may be helpful. The Federal Circuit in *Mellon* correctly states that Congress intended to "increase fairness, economic efficiency, and simplification of the tax system" by the tax reform proposals submitted in House Report 3838. *See Mellon*, 265 F.3d at 1281. The application of a floor on employee business expenses and miscellaneous itemized deductions was among the many tax proposals submitted to Congress by President Reagan in 1985. *See* H.R. Rep. 99-426 (1985); S. Rep. 99-313. We agree with the Federal Circuit that the purpose was to "simplify" the tax system. However, the manner of achieving this goal was expressly stated in the Senate Finance Committee Report ("*Senate Report*"). Sen. Rep. No. 313, 99th Cong., 2nd Sess., pt. 1 (1986). The Senate Report states that the committee desired a simplified tax system

and sought to achieve this goal by replacing "more than a dozen tax rates" and placing restrictions on "personal deductions." *Id.* This does not correlate to placing restrictions on deductions when a trust is involved. As explained below, non-grantor trusts are treated for tax purposes as an entity separate from its owner. The goal of simplifying the tax system for individual taxpayers does not necessarily overlap with simplification of the system for an entity taxpayer, which by the nature of its existence cannot be taxed in the same manner as an individual. The Federal Circuit erred in assuming that the second clause in I.R.C. § 67(e)(1) was a way to "simplify" the tax system. The Senate Report clearly states that simplification was a goal for "*individuals* [that feared] the recordkeeping, paperwork, and computations necessitated by tax filing" (emphasis added). *Id.*

The Federal Circuit also accurately stated that the goal of the tax reform was to establish "fairness" in the system to ensure that individuals similarly situated were subject to the same tax liability. The Senate Report listed numerous ways in which "fairness" was sought including: (1) limiting the deduction for business meals; (2) severe limitations to deductions for attending investment seminars; (3) changes to employee eligibility for pension benefits; (4) elimination of the deduction for contributions to an IRA; (5) a substantial increase to the standard deduction to relieve many low-income families from tax liability; and (6) other means of creating fairness in the tax system. *Id.* There was no mention, however, that by limiting the exception for trusts from the 2% Floor that Congress intended to meet this goal of fairness. In fact, reading the second clause of I.R.C. § 67(e) as limiting the deductibility of investment expenses achieves a result quite opposite from fairness. Investment advisory expenses when incurred by a fiduciary are always proximately related to the fiduciary's duties under state law to invest prudently. An inequitable result is achieved when a cost is incurred to fulfill a fiduciary obligation, the cost therefore being by definition not personal in nature.

and yet a limitation aimed at preventing the deduction of personal expenses is imposed to preclude a full deduction.

Although "efficiency of the economy" was a goal of the 1986 tax reform, the legislative history is devoid of any language suggesting Congress believed limiting the exception for trusts from the 2% Floor would result in the intended efficiency. Incurring investment expenses has long been an ordinary and necessary activity of a trustee managing trust assets. A trustee should not attempt to gain the expertise or rely on their limited experience to conduct the trust's investment activities. Rather, a trustee should seek learned, sophisticated, and skilled investment advisors in order to obtain investment strategies and advice that take into account the specific fiduciary requirements of the trust or estate under administration. By interpreting the second prong of I.R.C. § 67(e)(1) as not allowing a full deduction for investment advisory expenses without regard to the 2% Floor, the Federal Circuit effectively encouraged inefficiency. Trustees that lack the requisite investment expertise are deterred from serving or, if they are unable to serve, seeking proper investment advice to perform their fiduciary duties.[8] Following the interpretation by the Federal Circuit, without any supportive legislative history, reaches a conclusion that is far from efficient for the industry or economy as a whole.

The assumptions reached by the Federal Circuit also overlooked the "reasons for change" expressly declared in Title I of the Joint Committee Report. *See* Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, JCS-10-87 (May 4, 1987) at 78. The Joint Committee Report acknowledged that miscellaneous itemized deductions "fostered significant complexity, and that some of these expenses have characteristics of voluntary personal expenditures." *Id.* Prior

8. Those trustees that are full-service trustees (a trustee that has investment expertise) are required to apportion their fees between investment advice and other trust administration. As such, there is no practical distinction on this issue between professional and non-professional trustees.

law resulted in "extensive recordkeeping with regard to what commonly are small expenditures" in order for taxpayers to deduct expenses. Congress wanted to strike a balance between taxpayers with small expenditures and other taxpayers with large expenditures having a significant impact on the individual's disposable income. *Id.* Additionally, Congress recognized the difficulty of the Internal Revenue Service to monitor and enforce deductions for such small amounts typically involved. By imposing the 2% Floor, Congress wanted to relieve the administrative burden for taxpayers as well as the Internal Revenue Service relating to these deductions. As stated in the Joint Committee Report, "Congress concluded that the imposition of the two-percent floor on miscellaneous itemized deductions constituted a desirable simplification of the tax law." *Id.*

In contrast to *Mellon*, there is no reference in the legislative history that the exception provided for "estates and non-grantor trusts" was intended "to *equate* the taxation of trusts with the taxation of individuals" (emphasis added). *Mellon Bank*, 265 F.3d at 1281. If the goal of Congress was to "equate" trust taxation to that of an individual, Congress would not have provided for an exception at all. The exception in I.R.C. § 67(e)(1) harmonizes the 2% Floor with the general taxation of trusts as separate from the beneficial owner. Proper administration of a trust encompasses seeking legal counsel when necessary, performing ongoing accounting, tracking changes in the beneficial owners, maintaining records of all assets, as well as developing strategies and reviewing the investments to ensure proper investment management consistent with the fiduciary duties imposed under state law and the requirements of the governing instrument. So long as the fiduciary obligations are satisfied, ensuring proper investment management may either be: (i) conducted by the trustee; or (ii) obtained by an independent investment advisor. The legislative history is absent any language that would suggest

that Congress intended to deny a deduction for these expenses and effectively carve out this fiduciary obligation.

Although the legislative history does not support that the 2% Floor was a method of reducing the use of trusts for tax avoidance, there was a significant change in tax rates for trusts in the Tax Reform Act of 1986. I.R.C. § 1(e). In Title XIV of the Joint Committee Report, the "reasons for change" to the taxation of trusts was to prevent the "avoidance of tax." *General Explanation of the Tax Reform Act of 1986*, Joint Comm. on Taxation, JCS-10-87 (May 4, 1987) at 1245. Congress believed that "by revising the rate schedule applicable to trusts" that the benefits of using trusts are "significantly reduced." *Id.* The Act revised the rate schedule by taxing the first $5,000 of taxable income at 15% and any taxable income in excess of $5,000 at 28%. *Id.* The conclusion reached by *Mellon* ignores the "*significant*" compression of the tax brackets for trusts.

D. I.R.C. § 67(e) Should be Interpreted to Allow Fiduciaries to Fully Deduct Expenses Proximately Related to the Trust Property, Including Investment Advisor Expenses, Incurred While Satisfying Their Required Fiduciary Obligations.

The legislative history clearly illustrates the intent of Congress to prohibit the use of pass-through entities[9] to avoid the 2% Floor. *Id.* at 78. However, Congress also intended to strike a careful balance between prohibiting the use of pass-through entities to circumvent the 2% Floor, and recognizing the unique tax and fiduciary circumstances concerning trustees.

Congress recognized the potential abuse of individuals using pass-through entities to avoid application of the 2% Floor

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9. Pass-through entities are entities that do not pay tax on income at the entity level. Examples of pass-through entities are partnerships, S corporations, and grantor trusts.

and enacted I.R.C. § 67(c).[10] The income and expenses of these entities is generally taxable or deductible by its partners and shareholders, respectively, and reported on their individual income tax returns. Therefore, it is appropriate that the individual owners are allowed to utilize deductions only to the extent such owner personally could have done so but for the existence of the pass-through entity. However, costs from pass-through entities cannot have a proximate relation to the duties of a fiduciary holding the pass-through interest because the fiduciary does not make the decision to incur them.

Grantor trusts[11] are another type of entity which cannot be used to avoid the application of the 2% Floor. Similar to a pass-through entity, a grantor trust is a special type of trust arrangement in which the grantor has a sufficient beneficial interest or has retained sufficient control that the grantor is treated as the owner of the trust assets for income tax purposes. Because of this imputed ownership, all items of income, deduction, and credit with respect to the trust assets are reported on the personal income tax return of the grantor. I.R.C. § 671. Therefore, the grantor's deductions relating to the trust must be limited by the 2% Floor.

In contrast, non-grantor trusts, such as the one at issue before this Court, differ fundamentally from other pass-through entities under the I.R.C. While partnerships, S corporations, and grantor trusts generally do not pay tax and pass all items of income to its owners, a non-grantor trust typically pays tax on income earned by the trust.[12]

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10. I.R.C. § 67(c)(1) of the I.R.C. directs the Secretary of the Treasury to enact regulations which prohibit "indirect deduction through pass-through entities of amounts which are not allowable as a deduction if paid or incurred directly by an individual."

11. Grantor trusts are defined and governed by Subpart E of Part I of Subchapter J of Chapter 1 of Subtitle A of the I.R.C..

12. *See* I.R.C. § 641, *et. al.* To the extent that Distributable Net Income (as defined in I.R.C. § 643(a)) is not fully distributed to the

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Non-grantor trusts are generally not favorable entities for taxpayers to reduce income tax liability. Non-grantor trusts are subject to higher tax rates because of the compressed income tax brackets found in I.R.C. § 1(e). Because a non-grantor trust is a separate taxpayer, unlike other pass-through entities, deductions that cannot be taken at the trust level generally do not pass to the beneficiaries.[13] Instead, the deductions are potentially lost even if the trust's entire taxable income is distributed. Consequently, a trust can cause its beneficiaries to be subject to higher taxes than if they owned the property of the trust directly.

These characteristics of non-grantor trusts under the I.R.C. support the proposition that I.R.C. § 67(e) should not be interpreted as an additional safeguard against taxpayers abusing non-grantor trusts in an effort to reduce personal tax liability. For example, suppose a non-grantor trust has taxable income of $100,000 and deductions subject to the 2% Floor of $2,000. The trust distributes all its income to a beneficiary who has $100,000 of other taxable income and $4,000 of other deductions subject to the 2% Floor. Because $2,000 of deductions are lost at the trust level, none of the deductions may be taken. If the beneficiary could report all the income and deductions on her personal tax return, $2,000 of the total deductions of $6,000 would be available to offset the $200,000 of taxable income.

I.R.C. § 67(e) should be interpreted as a tool for fiduciaries to deduct expenses proximately related to the trust property (such as investment advisor expenses) that are incurred while

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trust beneficiaries, the trust itself will pay tax on that income. This is typical when a non-grantor trust does not require the trustee to distribute all of the trust income annually or gives the trustee the discretion to distribute as much income as it deems necessary (as is the case in the *William L. Rudkin Testamentary Trust u/w/o Henry A. Rudkin*).

13. *But see* I.R.C. § 642(h) of the I.R.C. (unused loss carryover and excess deductions are distributed to the trust beneficiaries in the year of termination).

satisfying their required fiduciary obligations. The trustee holds the trust principal for the benefit of the trust beneficiaries and, therefore, must manage the property appropriately. As a result of this relationship, local law often requires trustees to uphold certain obligations, such as the duties of good faith, loyalty and impartiality among the beneficiaries, and the duty to account. *See, e.g.*, Fla. Stat. §§ 736.0801-0803, 736.08135. These obligations do not apply to an individual managing his or her personal assets.

Importantly, most jurisdictions require the trustee to prudently invest the trust assets. *See, e.g.*, Fl. Stat. § 736.0901 and Uniform Law Commission, *A Few Facts About the Uniform Prudent Investor Act, http://www.nccusl.org/Update/uniformact_factsheets/uniformacts-ss-upria.asp* (last accessed August 13, 2007). This "prudent investor rule" generally requires the trustee to invest trust property in a reasonable manner, balancing investment risk and return in the most economic manner possible, taking into consideration the trust purpose and its beneficiaries. *See* Uniform Law Commission, Summary of the Uniform Prudent Investor Act, http://www.nccusl.org/Update/uniformact_summaries/ uniformacts-s-upia.asp (last accessed August 13, 2007). Some of the considerations a trustee must consider when investing trust property include general economic conditions, inflation or deflation, total return from income or the appreciation of capital, and the other resources of the beneficiaries. Most local laws also require the trustee to properly diversify trust assets. *Id.*

Expenses incurred by a fiduciary in that capacity are not merely for the purpose of enhancing the investment performance of the assets under his or her control but are part of a fiduciary's duty to manage the trust assets for the benefit of others, not for personal gain. These expenses incurred in furtherance of this fiduciary relationship "could not" be incurred by an individual who has no potential liability for breach of a fiduciary duty with respect to such assets.

Regarding the investment advisory expenses at issue in this case, a trustee must incur those fees while carrying out the duties that the trustee has to the beneficiaries with respect to the trust assets under his or her control. A trustee is concerned with the interests of all trust beneficiaries and with the obligations and duties required of a fiduciary under local law, such as the duty prudently to invest trust assets. Failure to invest trust assets prudently may well subject a trustee or executor to liability far in excess of any trustee or executor fees his or her services may generate. These matters do not concern an individual investing for personal gain.

As a result, investment advisory expenses incurred by a trustee always have a relation to the trustee's fiduciary duties and obligations. For that reason, investment advisory expenses incurred in the administration of an estate or trust should be deductible under I.R.C. § 67(e) without regard to the 2% Floor. This interpretation of I.R.C. § 67(e) upholds the delicate balance between preventing the use of pass-through entities to enhance the deduction of personal expenses and permitting fiduciaries to properly discharge their fiduciary obligations.

E. I.R.C. § 67(e)(1) Requires a Connection Between the Cost Incurred and the Administration of a Trust by Stating that the Cost Must be One that "Would Not Have Been Incurred" if the Property Were Not Held in Such Trust.

Rules of statutory construction require that meaning be given to all words in a statute. *See Kawaauhau v. Geiger*, 523 U.S. 57, 62, 118 S. Ct. 974, 140 L. Ed. 2d 90 (1988) ("[W]e are hesitant to adopt an interpretation of a congressional enactment which renders superfluous another portion of that same law."). These rules prevent the second prong of I.R.C. § 67(e)(1) as no more than repetition of the first prong of I.R.C. § 67(e)(1) to exempt all trust and estate administration costs from the 2% Floor. To give meaning to the second prong of I.R.C. § 67(e)(1), it must be read to create two categories of trust administration costs: those that are subject to the 2% Floor and those exempt

from it. The question is what administrative costs did Congress intend to exempt from the 2% Floor by using the phrase "would not have been incurred if the property were not held in such trust or estate."

In the present case, the cost at issue is the cost of investment advisory expenses. I.R.C. § 212 is the relevant section of the I.R.C. which provides for the deduction of investment advisory expenses and would therefore be useful in determining how the words of I.R.C. § 67(e)(1) should be construed with respect to investment advisory expenses. *See* I.R.C. § 212. In order for investment advisory expenses to be deductible under I.R.C. § 212, such fees must be "ordinary and necessary under all circumstances, having regard to the type of investment and to the relation of the taxpayer to such investment." *See* I.R.C. § 212 and Treas. Reg. § 1.212-1(g). Investment advisory expenses are "ordinary and necessary" if such expenses are reasonable in amount and bear a reasonable and proximate relation to the production or collection of taxable income or to the management, conservation, or maintenance of property held for the production of income. Treas. Reg. § 1.212-1(d). I.R.C. § 212, therefore, requires that investment advisory expenses bear a proximate relationship to the investment and be considered in context, having regard to the type of investment and the relationship of the taxpayer to such investment.

Upon making the determination that investment advisory expenses are deductible under I.R.C. § 212 by determining that such fees bear a proximate relationship to the investment and by considering the relationship of the taxpayer to the investment and the type of investment, a trustee must determine if the deduction is limited by I.R.C. § 67(e). Such determination depends on whether the investment advisory expenses would have been incurred if the property were not held in trust. In answering this question, three circuit courts have used the description of "unique" to identify the type of costs that would not be subject to the 2% Floor (i.e., costs that would not have been incurred if the property were not held in trust).

O'Neill v. Commissioner, 994 F.2d 302, 304 (6th Cir. 1993); *Mellon Bank v. United States*, 265 F.3d 1275, 1281 (Fed. Cir. 2001); *William L. Rudkin Testamentary Trust v. Commissioner*, 467 F.3d 149, 153 (2nd Cir. 2006).

A cost is "unique" to the administration of a trust if such cost "would not have been incurred" if the property were not held in trust. The "unique" requirement of I.R.C. § 67(e)(1) should be read together with I.R.C. § 212 which requires that investment advisory expenses bear a proximate relationship to the investments, that the relationship of the taxpayer to the investment be considered, and that the type of investment be considered. Investment advisory expenses incurred in the context of a trustee and trust are "unique" because of the fiduciary context in which those fees are incurred.

Investment advisory expenses incurred in the context of a fiduciary relationship must, out of necessity, consider the fiduciary relationship. Any investment policy adopted by a trustee must consider the trustee's fiduciary duties to manage, invest and control assets for the benefit of the beneficiaries. Failure of the fiduciary to prudently invest trust assets may subject that fiduciary to personal liability, a liability not experienced by an individual investing his or her own assets. It is that fiduciary relationship and potential fiduciary liability that makes investment advisory expenses incurred in the context of trust administration "unique" as compared to investment advisory expenses incurred by an individual. Due to the nature of a trust and the responsibilities of a fiduciary, the costs incurred by trusts as a result of the fiduciary relationship are not and could not be personal in nature. In other words, the "fiduciary investment advisory expenses" would not be incurred if property were not held in trust and are therefore not subject to the 2% Floor.

This critical distinction between trust expenses incurred to fulfill fiduciary obligations (i.e., fiduciary investment advisory expenses) and those that are personal in nature (i.e., personal investment advisory expenses) has long been contained in the

tax law. Expenses to administer a decedent's estate, for example, are deductible under I.R.C. § 2053(a)[14] for estate tax purposes only if "actually and necessarily incurred in the administration of decedent's estate. Expenditures not essential to the property settlement of an estate, but incurred for the individual benefit of the heirs, legatees, or devisees, may not be taken as deductions." Treas. Reg. § 20.2053-3(a). I.R.C. § 67(e) should be construed consistently with I.R.C. § 2053.

F. I.R.C. §§ 67(e), 2053 Should be Construed Consistently.

In the context of the federal estate tax, I.R.C. § 2053 permits a deduction for administration expenses. I.R.C. § 2053(a). Thus, in a taxable estate, investment advisory expenses may be deducted in full for estate tax purposes. In the case of a nontaxable estate (for example, an estate with a surviving spouse where the unified credit and marital deduction combine to produce a zero estate tax), administration expenses are typically deducted on the estate's income tax return (as an income tax deduction) rather than the estate's estate tax return (as an estate tax deduction). Under current law, estate management expenses, which under Treas. Reg. § 20.2056(b)-4(b) expressly include investment advisory expenses, may be paid from the marital share of the estate without reducing the marital deduction. In other words, such expenses may be incurred and deducted for income tax purposes without any negative estate tax consequence, preserving a zero estate tax result because the marital deduction is not affected even though the expenses are charged against the marital share. However, if I.R.C. § 67(e) were construed, as Respondent proposes, when investment advisory expenses are deducted for income tax purposes, instead of being fully deductible as they would have been under I.R.C. § 2053 in the case of a taxable estate, they would become subject

14. I.R.C. § 2053(a) allows costs of administering certain property included in the decedent's gross estate but which is property not subject to claims of the decedent under local law subject to the time limitations contained in that section.

to the 2% Floor. Since the estate tax rate is higher than the income tax rate, this result creates a substantial inconsistency. A taxable estate receives a higher deduction against a higher tax, whereas a nontaxable estate receives a lower deduction against a lower tax. There is no policy justification for this anomaly.

G. The "Would Not" Limitation Contained in I.R.C. § 67(e) Should be Limited to Expenses Not Proximately and Causally Incurred in Furtherance of a Fiduciary Duty.

The I.R.C. contains nearly fifty (50) itemized deductions.[15] Several of these may be incurred by an individual, on the one hand, or a fiduciary, on the other. It is those deductions at which the "would not" limitation contained in I.R.C. § 67(e) should be confined. For example, both an individual and a fiduciary may realize a loss on account of a bad debt described in I.R.C. § 166 which is allowable under that section as an itemized deduction. Unless incurred in a trade or business, such a bad debt would be subject to the 2% Floor of I.R.C. § 67(a). Such a bad debt is not incurred by a trust as a result of a causal relation to the fiduciary nature of the taxpayer. Therefore, this expense falls within the "would not" limitation of I.R.C. § 67(e).

Similarly, expenses made subject to the 2% Floor of I.R.C. § 67(a) through the application of the "pass through" rule of I.R.C. § 67(c) would apply to a fiduciary to the same extent that it applies to an individual because such expenses are not incurred by the fiduciary by reason of the proximate causal relationship to the trust. Hence, an expense passed through as a deduction to a trust as a partner in an investment partnership.

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15. I.R.C. § 67(b) defines "miscellaneous itemized deductions" as itemized deductions other than those listed in the section as excepted from the definition. I.R.C. § 68 does not use the phrase "miscellaneous itemized deductions" but rather "itemized deductions" although certain expenses are excluded under I.R.C. § 68(c) from the definition of itemized deduction for purposes of I.R.C. § 67(a). Twelve itemized deductions are excluded from the rule contained in I.R.C. § 67(a); three are excluded from the rule contained in I.R.C. § 68(a).

therefore, would be subject to the 2% Floor as it would if passed through to an individual partner.

CONCLUSION

Despite the seemingly blanket coverage of the 2% Floor, I.R.C. § 67(e) excludes certain deductions for trusts from the 2% Floor. Specifically, this section provides, in part, that the 2% Floor does not apply to "the deductions for costs which are paid or incurred in connection with the administration of an estate or trust and *which would not have been incurred if the property were not held in such estate or trust.*" I.R.C. § 67(e)(1) (emphasis added). The language in I.R.C. § 67(e) should be interpreted consistently with other sections of the Code, particularly I.R.C. §§ 212, 2053. As a result, the second clause of I.R.C. § 67(e)(1) should be construed to require a "proximate relation" between the cost incurred and the fiduciary duties imposed under state law. The legislative history of the Tax Reform Act of 1986 does not support any intention of Congress to deny a full deduction when expenses are incurred by a trustee in connection with satisfying the trustee's fiduciary duties. Rather, the legislative history supports that the "would not have been incurred" language was intended to prevent the use of pass-through entities to avoid application of the 2% Floor. As recognized by the Sixth Circuit, expenses incurred by a fiduciary, in that capacity, are not merely for the purpose of enhancing the investment performance of the assets under his or her control but are part of a fiduciary's duty to manage the trust assets for the benefit of others. Therefore, investment advisory expenses incurred in the administration of a trust should be deductible under I.R.C. § 67(e)(1) without regard to the 2% Floor.

Respectfully submitted.

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